Pilla Talks Taxes

DAN PILLA'S MONTHLY TAX AND FINANCIAL BULLETIN

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Will the IRS Lose Its $80 Billion Appropriation?

The Headlines Suggest so, but the Reality is Different

In what is certainly the shortest bill with respect to revenue that I've ever seen emerge from the House of Representatives, the House voted on January 9, 2023, to rescind much of the $80 billion funding granted to the Internal Revenue Service (IRS) by the Inflation Reduction Act of 2022. The bill is H.R. 9092, known as the "Family and Small Business Taxpayer Protection Act" (Taxpayer Protection Act). It consists of just one sentence. That sentence provides that certain elements of the funding granted to the IRS by the Inflation Reduction Act "are rescinded."

Please note that the Taxpayer Protection Act does not resend the entire $80 billion appropriation. Only certain elements are to be cut. Those elements primarily include $45.6 billion specifically pointed at tax law enforcement, and another $25.3 billion for the support of law enforcement activities.

The Taxpayer Protection Act would leave in place the funding targeted for taxpayer services, including pre-filing assistance and education, filing and account services, taxpayer advocacy services, and other related services.

The low level of funding pointed at taxpayer assistance programs compared to enforcement funding betrays the thinking of much of Washington's elite. Just $3.18 billion of the $80 billion was

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ADS

earmarked for taxpayer services and education. Barely 4 percent of the windfall the IRS was to receive would have gone to actually helping taxpayers comply with the law, compared to 96 percent that was intended to be used to grind people into dust when they didn't comply.

This is one reason I opposed the funding bill in the first place. As I point out in the August 2022 issue of *PTT,* where I discuss the Inflation Reduction Act, the vast majority of the problems people have with tax compliance are not driven by tax cheating; they are the result of ignorance, which itself grows from the fact that we have a tax code that consists of more than 4 million words and which was changed more than 6,000 times just since 2001.

This is also why I challenged the current nominee for IRS Commissioner, Danny Werfel, to rebuild the IRS's prefiling education programs, along with its outreach functions to citizens and private-sector tax professionals. See my article: "White House Nominates New IRS Commissioner," *PTT*, Oct/Nov 2022.

Of all the government agencies in America, only the IRS touches every citizen, regardless of their age and regardless of their social, economic or cultural backgrounds. This is why outreach and education must be a major priority for the agency, not just an afterthought. This is also why our schools need to adopt a curriculum that teaches high school students the basics of tax law compliance. High school graduates don't know the difference between a W-2 and the WWF, and they *never* learn about enforcement issues until they are on the business end of an IRS notice of some kind.

With the House's passage of the Taxpayer Protection Act, the question now on everybody's minds is, what's next for the IRS in light of the Act's funding cut? Under the circumstances present in Washington, I believe that passage of the Act is merely ceremonial. While it passed the Republican controlled House, it will not pass the Senate, and thus, it will never find its way to the White House to be signed by President Biden.

The bottom line is the IRS will still get its money, and my challenge to the new commissioner remains the same: Will you meaningfully work to assist taxpayers in complying with a law that is, as James Madison warned against in Federalist No. 62, "so voluminous that it cannot be read, and so incoherent that it cannot be understood?"

Or, will you simply turn the dogs loose on those hapless taxpayers who find themselves unable to comply? Time will tell.

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How *Not* to Reconstruct Records

Don't Follow This Formula for Failure

Lost or missing tax records are a regular and widespread problem. People lose records for a myriad of reasons, including fire, flood, hurricane, etc. My current client had her storage shed broken into. The thugs ransacked the shed, destroyed personal photos and memorabilia, and made off with numerous boxes. Among those boxes were records related to the purchase and remodeling of her home. Now that the home has been sold, it's time to prove cost basis. This will have to be done by reconstructing, as best we can, evidence to show purchase price and costs of remodeling.

When it comes to deductions (or in my case, proving basis), the burden of proof is on the taxpayer. Even when one loses records through no fault of his own, the burden remains on the taxpayer. That means lost or missing records must be somehow reconstructed in order to carry the burden of proof. See my discussion of records reconstruction in ***How to Win Your Tax Audit***, chapter 6.

The reconstruction of records has long been permitted by law. In fact, certain Tax Court decisions suggest that one even has a duty to reconstruct lost record because he retains the burden of proof. Under *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2nd Cir. 1930), when a deduction cannot be fully substantiated due to lost records, the Court has the authority to approximate the allowable amount. However, the Court must have some factual basis for its estimate. Without some foundation of evidence to support the reconstructed amount, the Court is under no obligation to allow a deduction in any amount. I discuss the *Cohan* rule (and related Tax Court decisions) at length at pages 62-65 of ***How to Win Your Tax Audit***.

In the recent Tax Court case of *Eze v. Commissioner*, T.C. Memo. 2022-83 (August 2022), we get a pretty good lesson on how NOT to reconstruct records. Eze was a self-employed consultant selling tech products and services. He traveled using his car to visit medical offices and provide products and services to existing and potential customers. During the two years subject to the audit, Eze grossed about $115,000 and $143,000, respectively, from this business. The income was reported on Schedule C (C1), along with business deductions, which gave him reported net income from that business of about $80,000 and $100,000, respectively.

Eze filed a second Schedule C (C2) for his "handyman business." He did construction and residential rehab projects for individual customers. The reported gross receipts for that business were $21,000 and $29,000 respectively. His claimed expenses vastly exceeded his income. The claimed expenses created a loss of $63,000 and $81,000, respectively.

The losses reported on C2 almost completely offset the income from C1. For 2015, he reported taxable income of $3,314, and for 2016 he reported zero taxable income and claimed a refund of $714. Not surprisingly, the IRS audited those returns. The agent disallowed all Schedule C expenses for both businesses and mailed a Notice of Deficiency to Eze, who filed a Petition in the U.S. Tax Court challenging the disallowances.

In the Tax Court trial, Eze presented what he considered to be reconstructed records to support his deductions. The Court found Eze's records to be lacking in credibility. Let me address the key problems with Eze's reconstructions.

1. Mileage logs. Eze kept no contemporaneous records of his travel for either business. The

logs were reconstructed for the audit several years later. And while that alone is not a problem, he couldn't explain how he remembered any of the details that went into the reconstructions after so many years. Also, he exactly duplicated a number of travel entries from one year to the next. For example, in several instances, he claimed to have traveled to exactly the same city, on exactly the same day of the year, to see exactly the same client, over both years. Worse, he couldn't identify a single client who worked at any of the addresses he recorded in the reconstructed logs. In over 100 separate instances, the log entry merely said "visit client." Moreover, the logs were remarkably inconsistent when it came to distances traveled. Multiple trips to certain cities varied considerably in the distance he claimed to have traveled. Trips to cities far from home were said to have incurred fewer miles than trips to cities closer to home. Finally, he reported driving no personal miles at all, which is impossible. Considering all of the above (and more), the Court rejected Eze's reconstructed mileage logs.

2. Materials expenses. Schedule C2 reported "other" expenses, chiefly consisting of materials purchased, in the amount of nearly $68,000 and $84,000, for the respective years. These expenses were alleged to be construction materials and tools. Eze had a number of receipts from various home center box stores, but they were not his receipts. He did not explain how he came into possession of the receipts, but he acknowledged that the purchases were made by "another person." His only explanation for who the other person might have been was his wife and "maybe somebody else." Each receipt was for a cash purchase, often more than $5,000. He couldn't explain to the Court why he spent nearly $175,000 in materials over two years to complete just $50,000 worth of work during the same time. Even worse, he couldn't explain the purpose of $21,000 of the tools and machines that were shown on some of the receipts.

3. Cell phone expenses. Eze claimed a total of about $3,000 of cell phone expenses over the two audit years. He provided no bills, invoices or contracts to show any cell phone service expenses. In fact, he said he received no invoices from the cell provider, but "knew" that he owed fees each month. He said he went to the vendor's office, paid in cash and obtained a receipt. However, there were physical problems with the receipts. The amounts listed as "payments" did not align with the other numerical entries in the same column, and they were printed in a different font from all other numbers on the receipts. The Court concluded that the documents were photoshopped, with fictitious numbers inserted as payments.

Both Eze's evidence and testimony regarding his expenses lacked credibility. The explanation of his construction activities was so vague and implausible that the Court questioned whether he had a business at all. But even if he did, he completely failed to provide the Court with the factual basis for any allowable estimate of business expenses under the *Cohan* rule.

Eze v. Commissioner provides the formula for what *not* to do when it comes to reconstructing records. ***How to Win Your Tax Audit*** provides the formula for what *to* do. Follow that outline and you will win when it comes to lost or missing records.

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HOW TO WIN YOUR TAX AUDIT

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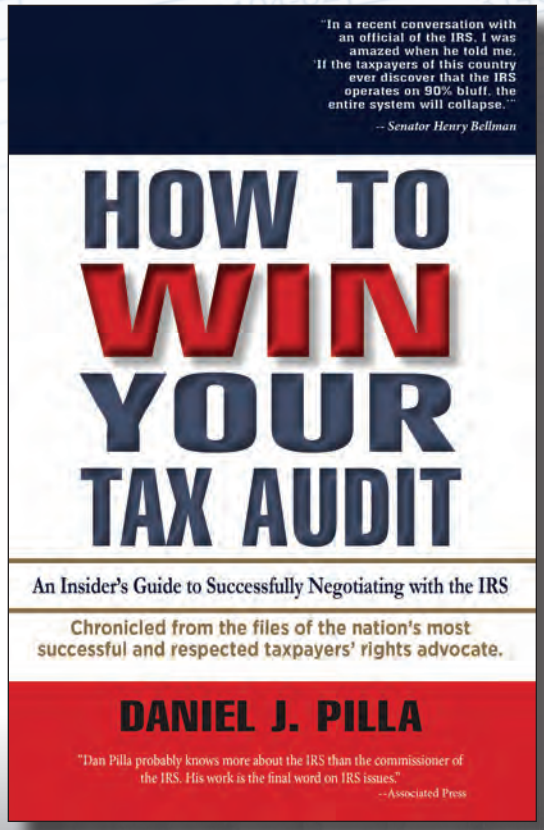

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The Status of The IRS's Processing Backlog

Are Things Improving?

As I reported in the August issue of *PTT*, 2022 was supposed to be the year that the IRS crushed the document-processing backlog. Instead, as of December 9, 2022, the backlog was still crushing the IRS. And things don't seem to be getting too much better.

As of the end of May 2022, the IRS was still facing 21.3 million unprocessed tax documents, consisting mostly of individual income tax returns. As of early December 2022, there were still 15.1 million documents waiting processing. Of these, 5.9 million are individual returns, and most of those claim a refund—which people are generally dependent upon. The following chart, reproduced from the National Taxpayer Advocate's (NTA) 2022 Annual Report to Congress, illustrates the precise nature of the current backlog.

FIGURE 2.1.5, Status of Inventory Requiring Manual Processing (as of December 9, 2022)

	Individual	Business	Not Specified	Total
Paper Returns Awaiting Processing				
Received in Calendar Year 2021				
Received in Calendar Year 2022	1,000,000	1,500,000	100,000	2,600,000
Total Paper Returns Awaiting Processing	1,000,000	1,500,000	100,000	2,600,000
Paper and Electronic Returns – Processing Suspended	4,300,000	1,600,000		5,900,000
Amended Returns Inventory	600,000	900,000		1,500,000
Total Unprocessed Returns	5,900,000	4,000,000	100,000	10,000,000
Correspondence/Accounts Management Cases (excluding amended returns)	2,000,000	800,000	2,300,000	5,100,000
Total Inventory Requiring Manual Processing	7,900,000	4,800,000	2,400,000	15,100,000

And while it's true that the IRS has made progress in cutting the backlog by 6.2 million documents since August, we are now on the threshold of yet another filing season that promises to bury the IRS in even more paper. Every year, the IRS is faced with the task of processing over 250 million paper and e-filed tax returns and related tax documents. The following chart, also from NTA's 2022 Annual Report, illustrates the return-filing volume in just the past four calendar years.

This chart does not even address the number of information returns that are filed—and must be processed—by the IRS each year. Information returns are Forms W-2 and 1099, which report payments to citizens by third parties. For example, Form W-2 reports wages paid by employers to their employees. In 2021, the IRS collected over 4.74 *billion* (that's with a B) information returns. This number grows steadily every year because the IRS is always pressing Congress (and Congress generally obliges) to add more and broader information reporting requirements to the law.

And while the lion's share of information returns is submitted in electronic format, the IRS was still faced with manually processing 2.747 million of those documents in paper form.

Even e-filed tax returns often must go through a manual processing phase, and as such, millions of e-filed returns are a part of the processing backlog. When the IRS's filters detect an error in an e-filed tax return,

FIGURE 2.1.2, Tax Returns Received by Type and Year

Returns Received – Type/Year	CY 2019	CY 2020	CY 2021	CY 2022
Paper Forms 1040	16,948,000	14,852,000	16,202,000	12,798,000
Electronic Forms 1040	138,047,000	152,232,000	151,765,000	151,429,000
Paper Forms 1040-X	2,882,013	2,486,555	2,129,027	1,029,097
Electronic Forms 1040-X	0	144,214	1,802,284	2,016,412
Paper Forms 941	12,770,328	11,594,459	10,775,793	1,942,919
Electronic Forms 941	12,093,323	12,939,196	14,199,749	15,629,173
Forms 941-X	325,718	338,678	738,422	1,369,000
Forms 1045	6,720	28,695	18,825	25,000
Forms 1139	4,360	22,882	16,337	14,000

a math error notice is mailed to the taxpayer. Automated processing of the return is suspended and the return is kicked out for manual processing in light of the error.

Millions of citizens made errors on their 2021 returns. Most errors involved the complex process of reconciling the Recovery Rebate Credit and the Advanced Child Tax Credit. As of November 2022, the IRS issued over 17 million math error notices relative to 2021 tax returns. Math error notices require a response from the citizen, and those responses were added to the pile of paper submissions that constitute the backlog of taxpayer correspondence. As of December 2022, the IRS was behind in processing 5.1 million pieces of correspondence from citizens.

The IRS told Congress and the public that the infusion of $80 billion in supplemental funding over the next ten years, and with that the hiring of nearly 87,000 new IRS employees, will allow the agency to get and stay ahead of the curve when it comes to data processing. I'm not sure that's the case. Even if the IRS is able to hire 87,000 more workers, the current rate of retirement and attrition within the agency will not put them ahead in net terms over time. By the end of this year, the agency is projecting that it could lose about 25% of its current workforce to retirement.

That aside, the IRS already missed an opportunity Congress provided to hire additional workers. The American Rescue Plan Act of 2021 gave the IRS $1.5 billion to hire additional employees for data processing purposes. Instead of doing so, the agency relied on reassigning existing staff to "surge teams" to address the backlog of paper documents. Clearly, that didn't work.

We may have reached the actual tipping point with the IRS; that is, the point at which the agency's demands for information and reporting from taxpayers it believes is needed to enforce the law has overwhelmed the agency's capacity to process and assimilate that very data. In other words, the agency is collapsing under the weight of the data monolith it created itself.

It's long past time we talk seriously about fundamental tax reform. That must include the ideas of abolishing the IRS and the income tax entirely.

Tax Court Addresses § 6751 Penalties

More Tortured Analysis of What Constitutes "Managerial Approval"

BY SCOTT MACPHERSON, ATTORNEY AT LAW *

In the June 2022 issue of *Pilla Talks Taxes* I reported on a Ninth Circuit decision, *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022). This case seemed to establish the rule that IRS revenue agents can mislead taxpayers regarding penalty assessments. I recently came across another Tax Court decision wherein Judge Lauber (who is infamous for handing down anti-taxpayer decisions) put forth the same rule in a different context. The case is *Oxbow Bend, LLC v. Commissioner*, T.C. Memo. 2022-23.

Both the *Laidlaw* Ninth Circuit case and the *Oxbow Bend* Tax Court case concerned the requirements of Code § 6751(b)(1). In *Laidlaw*, the Ninth Circuit addressed the statute with respect to clarifying what "initial" means in the context of an "initial determination" regarding the assertion of penalties. The court said that "initial" means "final" (LOL).

More specifically, a supervisor can approve a proposed penalty *after* the revenue agent mails his notice of proposed assessment, as long as the supervisor approves it *before* the penalty is actually assessed. In *Oxbow Bend*, the Tax Court addressed the manner by which that proposed penalty is conveyed to the taxpayer. According to Judge Lauber, a revenue agent can mislead the taxpayer whom he is auditing, with regard to a proposed penalty assessment.

The facts were fully stipulated and the case was decided on cross-motions for summary judgment. Petitioner Oxbow Bend acquired land and subsequently granted a conservation easement to a charitable foundation. Shortly thereafter petitioner donated fee simple interest to the same foundation. Oxbow timely filed a tax return claiming deductions for both the easement and the grant of fee simple. The IRS later initiated an audit.

On November 1 (the dates matter to the decision) the revenue agent, an attorney with the IRS Office of Chief Counsel, and Oxbow's representative, all discussed the case by phone. During that call the revenue agent informed Oxbow's representative "what the adjustments would be" and indicated the "penalties that were currently under consideration." *Oxbow* at *1. The agent explained that, once she completed her work, she planned to recommend that the case be "closed to issue an FPAA [final partnership administrative adjustment] instead of allowing [Oxbow] to go to Appeals." *Oxbow* at *1.

That same day the revenue agent prepared a penalty Lead Sheet to reflect her recommendation that penalties be asserted against Oxbow under sections 6662 and 6662A. On November 9, the revenue agent discussed with her manager the "potential penalties." Two months after that, in February, the revenue agent finally signed the draft penalty Lead Sheet and sent it to her immediate supervisor, who signed it the same day.

The Petitioner's argument was simple: In the phone call on November 1, the revenue agent proposed penalties. This is corroborated by the written penalty Lead Sheet that the agent filled out that same day. Code § 6751 covers those proposed penalties, and it requires that a revenue agent obtain supervisor approval *before* proposing those penalties. The revenue agent did not have her supervisor's approval on November 1. She did not even discuss it with her supervisor as of that date; that conversation occurred one week *after* the phone call. Her supervisor gave approval *ten weeks after that*, in February. Therefore, the 30-day letter was premature, and the penalty assessment was improper. *Id*. at *3.

As explained in the June 2022 *PTT* article, the point that Laidlaw argued, and that the Tax Court understood in Laidlaw's trial, was that the 30-day letter was issued before the penalty was approved—emphasis on *before*. That is a violation of § 6751. The Ninth Circuit in *Laidlaw* did not understand the difference between the words "before" and "after." Here, in the *Oxbow Bend* case, the Tax Court judge sidestepped the question by focusing on the *manner* of managerial approval, not on the *timing*.

Judge Lauber focused on the undisputed fact that the revenue agent did not provide Oxbow's representative—before, during, or immediately after the phone call—with any written document setting forth her penalty recommendations. The revenue agent did not ask Oxbow's representative to sign any formal or binding document, such as a waiver of restrictions on assessment. *Id*. at *3. Given these facts, the judge adopted the government's argument, which was that the decisions of *Excelsior* and *Tribune* controlled (discussed next).

In *Excelsior Aggregates, LLC v. Commissioner*, T.C. Memo. 2021-125, the examining agent convened a telephone conference with the taxpayer's counsel to discuss the status of the examination. Before the call she faxed the taxpayer's counsel an agenda, which set forth her tentative conclusions about the issues presented by the examination. During the conference she discussed the applicability of accuracy-related penalties, and she offered the taxpayer the opportunity to supply new information that might change her mind, such as the

possible availability of defenses to the penalties.

As to this exchange, the *Oxbow Bend* court noted (at *3) as follows:

> We held [in *Excelsior*] that the agent was not required to secure her supervisor's approval for the penalties before participating in that call. Rather, we held that the IRS had complied with the requirements of § 6751(b) because the "first formal communication" of penalties did not occur until the IRS issued the FPAA, which was mailed after the agent had secured written supervisory approval.

In *Tribune Media Co. v. Commissioner*, T.C. Memo. 2020-2, the taxpayers also asserted that the revenue agent was required to obtain his supervisor's approval before discussing penalties at a meeting. There, "[t]hat meeting, like the telephone conference here, was attended by the revenue agent and an attorney from the Office of Chief Counsel. During the meeting in *Tribune Media* the Chief Counsel attorney informed the taxpayers 'representatives that the Commissioner would apply a penalty to any underpayment determined.'" *Oxbow Bend* at *4 (internal citations omitted).

The Tax Court held that that statement did not embody the "initial determination" of any penalty because the IRS had yet to issue a "written communication purporting to determine a penalty with any sense of finality." *Id*. at *4 (internal citations omitted). "To adopt the taxpayers' argument, we concluded, would 'ignore the sense of formality implied by Congress's use of the word 'determination' and would render the examination of penalty issues unworkable." *Id*. at *4 (internal citation omitted).

Restated, in the interest of "concreteness and formality," the one that counts is a written proposal, not an oral proposal, whether it be by phone or in person, even when an IRS trial lawyer is a party to the conversation. According to this judge, the Office of Chief Counsel does not make a conversation "concrete" or "formal."

Rather, a phone conference with IRS Chief Counsel is subject to abuse and games by the taxpayer, the court said (*id*. at *5). Therefore, the revenue agent's approval must be issued in writing, and here (everyone agreed) the *writing* was mailed to the taxpayer in February, after the supervisor approved of the penalty (and some ten weeks after the phone conference wherein the revenue agent and the IRS Office of Chief Counsel expressed the agent's intention to impose penalties).

The conclusion, arrived at torturously, is that because the supervisor granted approval before the written proposal was mailed, the proposal was timely.

Scott MacPherson *is an attorney admitted in AZ, CA, and DC, and a long-time, second-generation member of TDI. He is a regular speaker at our Taxpayers Defense Conference and frequent contributor to* PTT. *Scott can be reached at 310-773-2042.*

American Business Owners Lose A Great Friend

It is with deep sadness that I announce the death of a great friend to American small businesses—and a dear personal friend of mine—Dr. Ronald R. Mueller, Capt. U.S. Navy (Ret).

I met Ron in the late 1990s, well after his Navy career was over. Ron's specialty was marketing. He helped small businesses with their marketing issues. That led him to explore small business tax issues, which then led him to write his book, ***Home Business Tax Savings Made Easy***. That book went through 21 editions as he revised and rewrote it every year to keep it up to date with the morass of annual tax-law changes.

I helped Ron with research and writing, and I presented a number of webinars to his customers and clients over many years. Ron was a big supporter of me, and I of him. In fact, Ron wrote the forward to my book, ***Dan Pilla's Small Business Tax Guide***.

Ron's book and his many reports helped thousands of small business owners, in particular home-based business owners, navigate the constantly changing waters of business tax deductions. And that's why Ron and I meshed so well: he focused on tax deductions, while I address IRS problems resolution. It was a perfect match.

Ron was a graduate of the United States Naval Academy. He earned a Master's degree from the University of Oklahoma, an M.B.A. from The American University, and a Doctorate in Business Economics from San Francisco Regent University. He had successful careers as a Senior Naval Officer and in international marketing, advertising, and investigative reporting.

He will be greatly missed.

How You Can Ask Dan Pilla a Question

If you have questions or problems you'd like Dan Pilla to address, please write to Dan at:

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